A Conceptual Framework for the Taxable Income of Businesses, and How to Apply it under IFRS

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by

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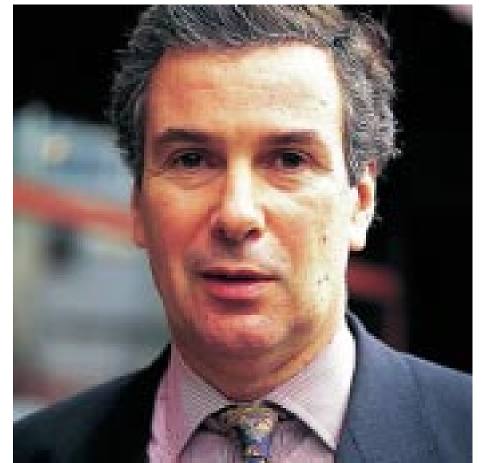

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1. Introduction

'In this world nothing can be said to be certain, except death and taxes.'
Benjamin Franklin, letter dated 13 November 1789

1.1 CONTEXT

Even the two certainties of the above quotation can now be questioned. The discovery of the contents of the human genome raises intriguing doubts about the former; and although it seems certain that some form of taxation will always be with us, corporate tax rates may continue their dramatic fall (perhaps to zero?) and the traditional starting point of the corporate tax calculation (i.e. pre-tax profit for financial reporting) may be abolished. A further important change is that the details of the calculation of financial reporting income are to be changed in 2005 by the adoption in the European Union (EU) of International Financial Reporting Standards (IFRS). In this report, the abbreviation IFRS is used to refer to the regime of using these standards for financial reporting. Although IFRS is required by the EU for listed companies' consolidated statements only, member states are allowed to extend this compulsorily or optionally to unlisted companies and to unconsolidated statements. Any extension to unconsolidated statements will lead to effects on tax calculations: taxable income will change or tax/reporting linkages will change, or both.

1.2 PURPOSE AND SCOPE

This report is designed to examine the present linkages between business income tax and financial reporting, and to ask whether they are ideal. The impact of adopting IFRS in a tax-neutral way will also be assessed.

Having noted an absence of a conceptual framework for the calculation of the taxable income of businesses, this report will propose one and then compare it with existing tax systems and with a starting-point of income measured under IFRS.

The report considers especially the situation of individual tax-paying entities (typically, companies) rather than group accounting, which is largely irrelevant for tax. Particular attention is given to the UK and Germany because (in 2003) they have the two largest EU economies and because they exhibit very different tax/reporting linkages. The EU is of special relevance because of the forthcoming adoption of IFRS for certain purposes. Tax/reporting links in other EU countries are generally rather like those of the UK (e.g. in Denmark, Ireland and the Netherlands) or rather like those of Germany (e.g. in Belgium, France and Italy). Reference to the United States is made where this is useful.

In general, the position at 31 December 2002 or at 31 March 2003 is analysed, as explained from time to time. Subsequent developments may affect the analysis.

1.3 CONTENT

Chapter 2 looks at the current operational links between tax and financial reporting for two countries that show markedly different degrees of linkage: Germany (close linkage) and the UK (many disconnections).

Chapter 3 examines the advantages and disadvantages of linkage, and concludes that the weight of argument favours disconnection of tax from financial reporting. The advantage of administrative simplicity is outweighed by the fact that tax and financial reporting have different purposes and by the risk of tax pollution and reduced flexibility.

The current links between financial reporting and tax are an obstacle to the adoption of IFRS for the financial reporting of individual companies. Chapter 4 looks at the adjustments that would be needed to the calculation of taxable income in the UK and Germany if IFRS were adopted.

If income is to be measured specifically for the purpose of taxation, as proposed in chapter 3, this implies the need for a conceptual framework upon which the calculation can be based. Indeed, since all tax systems envisage at least some adjustments from financial reporting income, the need for a framework is already implied. Chapter 5 looks at the limited previous research on this and at the analogy of the financial reporting framework. Chapter 6 then proposes a framework for tax and derives some rules from it for a number of accounting topics.

Chapter 7 compares the proposed tax base to the existing tax systems of three countries: the US, Germany and the UK. Then there is a specification of the standardised adjustments that would be necessary from IFRS to the proposed tax base.

Each chapter ends with a summary. These can be added together to make an executive summary. Finally, the report has three appendices containing support for some of the content of the chapters, a bibliography and a list of abbreviations used.

2. Current links between tax and financial reporting

'Income tax, if I may be pardoned for saying so, is a tax on income.'
Lord Macnaghten, *LCC* v *AG*, 1901.

2.1 INTRODUCTION

The links between the domains of tax and financial reporting can be divided into two types: (i) historical influences of the rules and practices of one domain on the development of the rules and practices of the other, and (ii) current operational effects of the rules and practices of one domain on the practices of the other. It is the latter, the current operational effects, that are relevant here.

In all countries known to the author, the calculation of taxable business income begins with the profit calculated according to financial reporting rules. The number and type of adjustments from that profit, however, vary greatly. For example, in Germany, a large proportion of companies have no adjustments, preparing an *Einheitsbilanz* (unified statement) for both financial reporting and tax purposes. At the opposite extreme, in the United States, there are very large numbers of adjustments, such that tax accounting is seen as a quite separate field of expertise from financial reporting. In between these extremes, French companies use a standardised form (2058-AN) to make the limited number of adjustments specified by tax law. One of the reasons for this international variation is that the purposes of financial reporting differ internationally. This is investigated in chapter 3.

In nearly all countries, *consolidated* statements are not directly relevant for tax. In some countries, there are ways in which certain members of an accounting group can be considered together for tax purposes, but the tax group is not the same as the accounting group (Lamb, 1995). This chapter considers specifically the financial statements of individual tax-paying entities.

Section 2.2 examines a technique for measuring the degree of closeness of tax and financial reporting in any country. Section 2.3 summarises the position for a country of close connection: Germany. Section 2.4 examines the complex case of the UK.

2.2 MEASURING LINKAGE

Lamb, Nobes and Roberts (1998) developed a technique for measuring, for any country, the degree of connection or disconnection of tax and financial reporting. Linkages for any accounting topic are put into five categories, as shown in table 2.1. Category I is disconnection of tax rules and practice from financial reporting rules and practice. This suggests lack of influence of tax on financial reporting decisions. The other four categories involve various forms of connection. Category II is where there are tax rules and financial reporting rules without major options, and the two sets of rules are the same. This suggests that there is limited room for tax considerations to affect accounting policy choice by managers. In Category III, the accounting rules are more detailed than the tax rules, and tax practice is to follow accounting practice. Initially, this suggests the influence of accounting on tax. Where the accounting rule allows choice or is vague, however, there may be a 'reverse effect' whereby the financial reporting rules (or options in them) are chosen, interpreted or shaped with the tax effect in mind. Examples of Category III where such a reverse effect seems more likely are shown as 'III†' in table 2.2.

Table 2.1: Categories of linkage between tax and financial reporting

Category I	Disconnection	The different tax and financial reporting rules (or different options) are followed for their different purposes.
Category II	Identity	Identity between specific (or singular) tax and financial reporting rules.
Category III	Accounting leads	A financial reporting rule or option is followed for both financial reporting purposes and tax purposes. This is possible because of the absence of a sufficiently specific (or singular) tax rule.
Category IV	Tax leads	A tax rule or option is followed for both tax purposes and financial reporting purposes. This is possible because of the absence of a sufficiently specific (or singular) financial reporting rule.
Category V	Tax dominates	A tax rule or option is followed for tax and financial reporting purposes instead of a conflicting financial reporting rule.

Table 2.2: Tax linkage in material topics of financial reporting

		Connection or disconnection case	
		Germany	***UK***
1.	Fixed asset recognition and valuation	III, IV (and sometimes V)	I
2.	Financial and operating leases	IV	III†
3.	Depreciation (normal)	IV	I
4.	Depreciation (excess)	V	N/A
5.	Contingencies, provisions	III†	I (possibly III)
6.	Grants and subsidies	IV	I
7.	Research and development costs	III†	I
8.	Inventory valuation (flow assumptions)	IV	II
9.	Inventory valuation (other areas)	IV	III†
10.	Long-term contracts	III	III (in most cases)
11.	Interest expense (capitalisation)	III	I
12.	Interest expense (other)	III	II
13.	Foreign currency transactions	III	I*
14.	Non-consolidation purchased goodwill	V	I
15.	Pensions	IV	I
16.	Policy changes and fundamental errors	III	I

Key: I–V As defined in table 2.1
* Strictly Category I, but measurements are identical in normal circumstances.
N/A Not applicable, because there is no distinction for accounting or tax between normal and excess depreciation.
† Examples of Category III where a reverse effect (i.e. tax considerations influencing financial reporting) seem particularly likely.

Source: adapted from Lamb, et al. (1998).

Categories IV and V are clearer examples of tax influence on accounting policy choice. In IV, there is no precise financial reporting rule, so a tax rule is followed for convenience or a tax option is chosen in order to reduce tax liabilities. In Category V, financial reporting rules are overridden.

Lamb et al. suggested a number of accounting topics which can be categorised. The first column of table 2.2 lists these, chosen on the basis that they were sufficiently important to warrant coverage by an International Accounting Standard.

Given the general reliance of tax rules on financial reporting practice, for any country, it is not surprising that there are many examples of II and III conformity; to this extent, we could regard such conformity as the 'normal' state of affairs in any country. For example, on the whole, the tax rules do not specify treatments for such issues as sales, wages and most business overheads, so Category III conformity is normal.

The way to distinguish countries is to measure the number of Category I disconnections and the number of Category IV and V tax influences. Section 2.3 summarises the position for Germany, where there are few examples of Category I but several examples of IV and V. The reverse applies in the UK, as explained in section 2.4. The positions for France and the US are also examined by Lamb et al., but not here.

2.3 TAX DOMINANCE IN GERMANY

A polar case of close connection is the financial reporting system for individual legal entities in Germany. The formal legal position is that the calculation of taxable income rests upon the calculation of commercial profit: the *Massgeblichkeitsprinzip*[1] (Haller, 1992). There are thus many examples of Category III connection. There are also many examples of Category IV (tax leads), however, such as:

- use of the tax law's 15-year write-off period for non-consolidation purchased goodwill, rather than the four-year period found in commercial rules (unless a longer period can be justified)
- the tax law's maximum rate of 30% for declining balance depreciation is, in practice, not usually exceeded for accounting purposes
- the accounting option to include production overheads is generally taken up following the tax requirement to include them
- the accounting option to provide for pension commitments relating to the period before 1987 is generally not taken up

1. The principle of congruents

- the tax decrees of the Ministry of Finance are followed for determining whether a lease should be capitalised
- the use of maximum depreciation rates allowed by tax law
- changing depreciation method from reducing balance to straight-line for an asset when this would increase the expense
- charging six months' depreciation on assets bought in the first half of the year and a full year's depreciation on assets bought in the second half

  and

- calculation of pension expenses on the basis of interest rates and other assumptions in tax rules.

The result of this is that, in effect, financial reporting rests on tax considerations (the *umgekehrtes Massgeblichkeitsprinzip*[2]), rather than the other way round. The position for Germany is summarised in table 2.2.

2.4 TAX AND FINANCIAL REPORTING LINKS IN THE UK

Overall position

As with other countries, accounting profit is clearly the starting point for the calculation of taxable income in the UK. Freedman (1995) analyses the relationship between financial reporting rules and tax, including the case of *Odeon Associated Theatres Ltd.* v *Jones*, where it was held that:

> *'The concern of the court in this connection is to ascertain the true profit of the taxpayer … . In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word 'correct' deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sense of principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the court will agree with the accountants but it will not necessarily do so … . At the end of the day the court must determine what is the correct principle to be applied.'*

---

2. The reverse principle of congruents

Elsewhere, Freedman (1987, p. 65) notes that in the UK, in the nineteenth century, taxable profits were deemed to be those in accordance with 'commercial principles' used by ordinary businessmen, but that this gradually changed because the courts increasingly referred to accountants rather than to businessmen, and then gave the term a technical rather than an ordinary meaning.

Where there is no specific tax law to the contrary, recent UK case law has helped to clarify the position that modern accountancy practice will apply in normal circumstances. Despite the possibility that established legal concepts could overrule accountancy practice, a judge's ruling

> '*will not override a generally accepted rule of commercial accountancy which (a) applies to the situation in question*[,] *(b) is not one of two or more rules applicable to the situation*[,] *and (c) is not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business'.* (Freedman, 1993, p. 477)

Cases such as *Anaconda*, which ruled against last in, first out (LIFO), showed that the courts could choose, for tax purposes, from a variety of acceptable accounting practices. In making these choices or in departing from accounting practice, the courts have laid great stress on two principles originally taken from accountancy practice: the capital/revenue distinction and realisation.

Accounting practice has become more closely specified, however, as a result of the arrival of accounting standards (from 1970), the Companies Act 1981 (now the 1985 Act) and the improved status and detail of standards (from 1990). Consequently, the tax authorities and the courts have been increasingly willing to rely on accounting rules.

This tendency was made even clearer by section 42 (1) of the Finance Act 1998.

> 'For the purposes of Case I or II of Schedule D the profits of a trade, profession or vocation must be computed *on an accounting basis which gives a true and fair view*, subject to any adjustment required or authorised by law in computing profits for those purposes' (emphasis added).

One of the specific purposes of this piece of law was to remove the cash basis used by certain taxpayers, but there is the more general effect of reinforcing accounting rules. This was made even clearer by section 103 of the Finance Act 2002, which replaces the words emphasised in the above quotation with 'in accordance with generally accepted accounting practice'.

Specific accounting links

In terms of the five categories of linkage discussed in section 2.2, the treatment of lease accounting is an example of an unusually complex Category III relationship. The capitalisation of leases was unusual in the UK before the passage of Statement of Standing Accounting Practice (SSAP) 21 in 1984. The Accounting Standards Committee (ASC) confirmed with the tax authorities that the application of SSAP 21 would not alter the tax position, i.e. rental payments under all leases would remain deductible expenses for tax purposes (a Category I disconnection). A subsequent Inland Revenue Statement of Practice (confirmed by case law), however, requires the tax basis to follow the accounting basis in normal circumstances (a Category III relationship). Accounting leadership is established by reference to the categorisation of leasing agreements as ‘operating leases’ or ‘finance leases’.

Rental payments for operating leases are deductible in arriving at profit measured for financial reporting and tax purposes. In contrast, under new Inland Revenue practice ‘inspectors will normally be prepared to accept that the properly computed commercial depreciation of the asset which is charged to the profit and loss account in the period’ together with the finance charge element of finance lease rentals, represent the appropriate tax deduction. In principle, there are no major choices in the accounting rules. Given the amount of judgement required to distinguish an ‘operating lease’ from a ‘finance lease’ under the terms of SSAP 21, however, there may be a reverse effect (as for many other Category III areas), in that the directors may wish to capitalise, or not, for tax purposes and therefore may seek to apply SSAP 21 in particular ways.

The UK treatment of provisions is a topic generally characterised by Category I disconnection. Tax law tends to distinguish between ‘general provisions’, which are not deductible for tax purposes, and ‘specific provisions’, which are. Specific legislation and case law have together established the clear distinction between ‘general’ and ‘specific’ in relation to provisions for bad debts and repairs.

Many other material topics in UK financial reporting involve quite separate rules for tax and financial reporting (Category I). Fixed assets and their depreciation provide good examples of this. It is provided in law that fixed assets may be revalued in various ways, and this is common practice in the UK, particularly when property prices are rising. Revaluation (upward or downward) is ignored for tax purposes. Similarly, depreciation for financial reporting purposes is controlled by company law and accounting standards, but is not deductible against taxable income. Instead, a scheme of capital allowances sets out the available tax depreciation.

The position for the UK is summarised in the last column of table 2.2, based on the research of Lamb et al. (1998). Since 1998 there have been further examples of tax practice following changes to financial reporting rules, most notably in the narrowing of the definition of a provision caused by FRS 12 (Inland Revenue, 1999b). Also, the Finance Act 2002 introduces a treatment for intangible assets based on FRS 10.

SUMMARY

- The calculation of taxable business income begins with accounting net profit, which is then adjusted slightly or greatly depending on the country.

- For any particular accounting topic, the connection between tax and financial reporting can be put into one of five categories. A study of 16 topics (listed in table 2.2) on this basis confirms a noticeably closer tax/reporting relationship in Germany than in the UK.

- The tax linkages in the UK are complex, and there has been a tendency for the tax authorities to follow developments in financial reporting.

3. Separate tax and financial reporting systems

3.1 INTRODUCTION

As examined in chapter 2, there is a very close linkage between taxable income and financial reporting in some countries, for example, Germany. In the UK, linkage is not close for some accounting topics, but governmental policy has sought to increase linkage in general. In 2002, an Inland Revenue (2002) consultation document proposed that, as far as possible:

> '*definitions of what constitutes taxable profits should be aligned with those used for business or economic purposes, unless there are good policy reasons for a difference …'* (p. 7)

It will be suggested in this chapter that the 'good policy reasons for a difference' are so numerous and convincing that the presumption in favour of linkage should be reversed. In a subsequent document, the Inland Revenue moved away from the idea of close alignment (2003, e.g. paras. 1.12, 1.14, 2.19, 2.20).

This chapter now looks at the arguments in favour of alignment and then at five arguments in favour of the continued or extended de-coupling of tax calculations from financial reporting: different purposes, reducing tax pollution, facilitating differential reporting, allowing developments in tax or financial reporting, and facilitating an international tax base.

3.2 IN FAVOUR OF ALIGNMENT

The substantial argument in favour of the alignment of tax practice with financial reporting practice is one of administrative efficiency. If the two systems use the same practices, then accounting need be done (and checked) only once. The full advantage of this can only be achieved where the tax rules are *exactly* the same as the financial reporting rules; in other words, if there are no tax rules. As soon as tax rules are enacted in order to stop abuse or to add options, the advantage of convergence starts to fall away. For example, the Inland Revenue (2003, para. 2.57) remain in favour of using the concept of finance leases in the tax context but without using exactly the accountants' definition of a finance lease.

Another advantage that might be claimed for convergence is that the natural tendency for some companies to exaggerate their profits can then be restrained by the tax consequences.

This point seems to relate mainly to listed groups because others have less incentive for optimism. It assumes that the tax-relevant parent accounts are aligned with the tax-irrelevant group accounts; this may now be the case in the UK, given FRS 18's requirement (para. 17) to adopt the most appropriate accounting policies. This alleged advantage is not very convincing because it relies on the very blunt instrument of tax-driven conservatism for certain types of companies.

A related issue is that a lack of tax/reporting alignment can damage the tax system by enabling companies to find tax-relevant costs or losses that are never incurred for reporting purposes.

3.3 DIFFERENT PURPOSES

If the purposes of tax and financial reporting are significantly different, then we should start with the presumption that the calculation of income for tax and for financial reporting purposes should also be significantly different. Whittington (1995) warns that separation between financial reporting and tax may be necessary because of differences in their purposes, which are increasing. This conclusion is widely agreed (e.g. Freedman, 1995; Green, 1995; Macdonald, 2002, p.3).

The purposes of tax and of financial reporting are now briefly surveyed. The main purpose of most taxes is self-evidently to raise revenue for the government. There are several other aims, including:

- redistribution of income, for example by taxing the rich more than the poor
- re-allocation of resources, for example by encouraging investment in certain types of equipment or parts of the country by granting generous tax depreciation allowances
- political or paternalistic objectives, for example taxing tobacco in order to discourage its use

  and

- stabilisation of the economy, for example by lowering tax rates in a recession.

These are not sub-aims of revenue raising; they are different and sometimes competing purposes. For example, if the paternalistic aim of tobacco taxation were ever fully achieved, it would lead to a disastrous loss of revenue. Fortunately for revenue raising, addictive goods have highly inelastic demand.

This report is concerned particularly with the taxation of business income. Even for this category of taxation, most of the objectives are potentially relevant. For example, a political objective could be the encouragement of small businesses, which might be achieved by applying lower tax rates or offering more generous capital allowances. As is often the case, political and economic objectives are hard to disentangle here. The existence of multiple objectives makes it more difficult to design a tax system to best serve the objectives.

Turning to financial reporting, it is clear that its objectives are quite different from those of taxation. Once again, there are multiple objectives. In the UK, these include (ASB, 1999, para. 1.6):

- giving useful information about a company to existing and potential shareholders and lenders so that they can best predict future cash flows in order to make financial decisions

  and

- enabling the existing shareholders of a company to assess the quality of stewardship exercised by directors.

As with taxation, the existence of multiple objectives complicates the task of the rule-makers. It is unlikely, however, that a form of accounting designed to serve the various objectives of financial reporting would be ideal for serving the quite different objectives of taxation.

In some other countries, the purposes of financial reporting are different. For example, in Germany there has historically been a concentration on the calculation of prudently distributable profit, in order to protect creditors. Indeed, for some businesses in some countries, the main purpose of annual reporting seems to be the calculation of taxable income. These purposes will affect how easy and appropriate it is to align tax and financial reporting.

In chapter 4 of this report, there is a closer examination of the tax objectives, and an attempt to construct a framework that leads from tax objectives to tax principles and rules.

3.4 REDUCING TAX POLLUTION

A second reason for a presumption in favour of separating tax from financial reporting is the need to protect financial reporting from ‘tax pollution’. The financial reporting system in Germany is a case study in tax pollution. In chapter 2, the links between the German financial reporting and tax systems were examined. The effects of this on the behaviour of company

management are clear: assuming that the company is profitable and that tax rates are not expected to fall, management is commercially obliged in any year to charge the highest expenses allowable for tax purposes. For example, it makes sense:

- to charge the largest depreciation expenses allowed for tax purposes even if they are economically unrealistic

- to write down assets to the maximum allowed for tax purposes even if this exceeds any reasonable impairment loss.

Similarly, in practice, the tax rules for lease capitalisation and pension expenses are followed for financial reporting.

In summary, the effect in Germany is that:

- although, in principle, tax accounting should follow financial reporting rules (the *Massgeblichkeitsprinzip*), financial reporting is in practice operated with its tax effects in mind

  and

- for many topics, the tax rules are followed for financial reporting purposes, and the tax courts are the final arbiters of rules that affect financial reporting.

It is now possible, however, for German companies to avoid tax pollution in their *consolidated* financial statements by using IFRS or US accounting rules.

Another good example of tax pollution is the use in the US of LIFO. When inventory prices rise, LIFO leads to a fall in income. LIFO is only allowed for tax purposes, however, if it is used for financial reporting. The practice of some large US companies is noted in table 3.1, which shows that use of LIFO for at least some inventories is majority practice. This is designed to reduce taxation. Because LIFO gives misleading balance sheet measures of inventory, the US regulators require disclosures of first in, first out (FIFO) numbers. For examples of the large effects of the use of LIFO, see table 3.2. In the case of *Caterpillar*, the net current assets would increase by 60% when adjusting from LIFO to FIFO, and the net assets by 36%.

Even in cases where the tax rules on a particular topic are vague, allow choices or are non-existent, management might choose financial reporting policies with their tax results in mind. Lamb et al. (1998, p. 174) discuss this 'feedback' effect for the UK and the US for topics where superficially there is dominance by financial reporting rules. This more subtle type of tax 'pollution' can also be addressed by establishing separate sets of rules.

Although tax pollution is not an *intended* effect of the close linkage of tax and financial reporting, it is an *inevitable* effect. It is an example of offending Adam Smith's (1776) canon of neutrality: behaviour is adversely affected as an unintended result of the tax.

Table 3.1: Use of LIFO by 600 US companies

	Instances of use
FIFO	404
LIFO	301
Average cost	176
Other	34
	915
	Companies
Use of LIFO by the 301 companies above:	
For all inventories	24
For 50% or more	159
For less than 50%	83
Not determinable	35

Note: This table shows methods used by 600 large companies. A company may use more than one method.

Source: *Accounting Trends and Techniques*, AICPA, 2000, p.207.

Table 3.2: Effects of adjusting inventory from LIFO to FIFO

	LIFO $m	*Adjustment $m*	*FIFO ($m)*	*% Increase*
General Motors (2002)	9,967	1,807	11,774	18
Caterpillar (2002)	2,763	1,977	4,740	72

Source: compiled by the author from published company reports.

3.5 FACILITATING DIFFERENTIAL REPORTING

There are good arguments for establishing different financial reporting rules for different types of entities; for example, a difference between listed and unlisted companies. The basic argument is that the purpose of financial reporting is likely to be different for companies with thousands of outside shareholders and for those with none. If the purpose is different, the financial reporting should probably be different. At its simplest, unlisted or small companies could be entirely relieved from statutory financial reporting, in which case they could arrange their accounting to suit tax requirements only. This describes the position for many smaller enterprises even in the UK. Alternatively, certain companies could be exempted from some disclosures; for example, IFRS offers unlisted companies relief from segment reporting (IAS 14, para. 3) and from disclosures of earnings per share (IAS 33, para. 1). A more extensive set of reliefs is offered for smaller companies in such countries as the UK and New Zealand. The UK's Financial Reporting Standard for Smaller Entities (FRSSE) can be used instead of other accounting standards and contains a greatly reduced set of disclosure requirements.

In general, standard setters have been opposed to differential *measurement* rules, but the simplification of rules may sometimes justify differences in measurement. Such a move will be constrained unless the principle of the separation of tax and financial reporting is accepted.

3.6 ALLOWING DEVELOPMENTS IN TAX AND FINANCIAL REPORTING

Similar arguments to those about differential reporting, given above, apply to facilitating changes in tax or financial reporting. Let us suppose that there is a strict tax linkage. It then becomes impossible to change tax rules without an unintended effect on financial reporting, and vice versa. For example, suppose that a consensus emerges among users in favour of adopting marking-to-market for the financial reporting of financial assets. This would involve the recognition of gains earlier than the traditional measurement at the lower of cost and market. Even if companies were otherwise in favour of a move to marking-to-market, they would oppose it because of the expected tax effects.

An extreme example of developments in financial reporting is IASB's proposed replacement for the conventional income statement. This would mean that the conventional starting point for the calculation of taxable income (i.e. current version of net profit before tax) would no longer exist. Such a move would be successfully opposed in a country that had close tax linkage and a powerful tax authority. Again, if the tax authorities in a country with a close tax linkage introduced a 100% immediate tax depreciation for certain assets, areas or periods, in order to encourage investment, this would result in an unintended temporary reduction in company earnings as reported to investors.

In order to avoid these problems, it is necessary to introduce a presumption that changes to financial reporting should not affect taxable income, and that changes to tax rules should not need a change in financial reporting practices in order to be effective.

A further example is a practical constraint on the adoption of IFRS. The desire to maintain tax linkages is presumably a major reason why many governments in continental Europe are not proposing to require or to allow the application of IFRS for individual company financial reporting in 2005 onwards, even when IFRS will be compulsory or optional for consolidated statements. The tax linkage is therefore a block on harmonisation and the cause of inefficiency (in that it requires many companies to prepare two sets of financial reporting numbers: using domestic rules for unconsolidated but IFRS for consolidated).

3.7 FACILITATING AN INTERNATIONAL TAX BASE

Great inefficiencies result from international tax differences. Multinational companies spend extensively on tax experts to understand tax differences in order to minimise global tax bills. Tax experts can create expenses that are deductible in more than one country and revenues that are taxable nowhere. Tax authorities then need to devote resources to disentangling the devices used. This 'arms race' is inefficient. The corporate sector as a whole does not gain, because the tax authorities will raise tax rates in order to collect the necessary revenue, so the compliance and collection costs are a burden on economies. It would be more efficient to have an internationally agreed definition of taxable income. This would not imply the use of the same tax *rates* in all countries. For example, in the US, there is a federal definition of taxable income, which still allows different tax rates for corporate income tax at the state level. The existence of differential tax rates would continue to encourage transfer pricing manoeuvres, but other wasteful effort would be reduced.

Although universal agreement on the definition of taxable income is an unrealistic target, benefits could still be obtained by less ambitious moves in this direction. First, groups of countries (e.g. the EU) might wish to develop a harmonised tax base (see the latest EU proposal in section 7.1). Given the continuing existence of international differences in

financial reporting, the development of a harmonised tax base would be easier if tax issues were disconnected from it. Secondly, complete standardisation of the tax base is not necessary in order to gain some benefits. For example, international agreement that, for tax purposes, all leases are operating leases would increase tax efficiency.

SUMMARY

- In some countries (e.g. Germany), there is a presumption that taxable income should be the same thing as financial reporting income. In other countries (e.g. the UK) there is also a general presumption in favour of alignment.
- The arguments in favour of alignment include administrative efficiency and that it could act as a brake on exaggeration of profits. However, there are strong arguments against alignment (see five points below).
- The purposes of financial reporting, at least for some types of entities, are clearly different from the purposes of taxation, which raises the possibility that the calculation of income should be different for the different purposes.
- Strong links between tax and financial reporting tend to lead to manipulation of the latter in order to reduce tax bills. This reduces the usefulness of financial reporting.
- If a jurisdiction wishes to impose different financial reporting requirements on different types of entity, it would be useful to be able to do this without affecting taxable income.
- The links between the tax system and financial reporting act as a constraint on the development of both.
- Some international harmonisation of the tax base would be economically efficient, and this would be easier if the tax base could be altered without affecting financial reporting.

4. The effects on current tax calculations of moving to IFRS

4.1 INTRODUCTION

The conclusion of chapter 3 is that tax and financial reporting ought to have separate rules. The advantages of this should become especially obvious to tax authorities if financial reporting rules are set by a body which is not only non-governmental but also *'foreign'*, and which keeps changing its rules and is not interested in tax. The latter is a description of the IASB.

Let us suppose, then, that the government of any country would be prepared to accept or require IFRS for individual tax-paying entities only if tax were unaffected and therefore separated from financial reporting. This chapter specifies the adjustments that a company would have to make to its current tax calculations if IFRS were adopted in a tax-neutral way for financial reporting in the UK and Germany.

It would be possible to be more ambitious. For example, an EU-wide tax base linked to IFRS could be created. It has even been suggested that this could apply to consolidated income. Later in this report, these issues are considered, a purpose-built tax base is proposed, and standardised adjustments to it from IFRS are derived. For this chapter, it is assumed that there are no changes to the various national tax bases.

4.2 EFFECTS OF MOVING TO IFRS ON UK TAX CALCULATIONS

It was assumed in the introduction above that, if the UK government were to require or allow IFRS reporting by individual companies, it would want to do so in a tax-neutral way. One report (ICAEW, 2003) takes the opposite assumption in its summary of the impact of moving to IFRS, i.e. that tax calculations will continue to follow the accounting treatments even when changes in these would lead to large effects on tax. At the very least, the government would wish to know the likely effects on taxable income if IFRS were adopted without an attempt to make this tax-neutral. This section looks at the changes that would occur to the starting point for tax calculations (i.e. pre-tax profit) if IFRS were adopted.

Moving from UK requirements to those of IFRS affects hundreds of potentially significant issues (Cairns and Nobes, 2000). Not all these, however, would affect the pre-tax income of taxpaying entities. For example, many issues affect only disclosures or presentation. Some affect reserve movements, many concern consolidation. Further, some existing differences

Table 4.1: Effects of adopting IAS (2003) on profit

		UK	*Germany*
IAS 2	No LIFO	NC	+
IAS 2	NRV not replacement cost	NC	+
IAS 8	Prior-year correction of errors/policies	NC	+/-
IAS 11	Profit on uncompleted contracts	NC	+
IAS 16	Depreciation slowed	NC	+
IAS 17	Lease capitalisation	NC	+/-
IAS 19	Pension expenses altered	+/-	-
IAS 21	Unsettled exchange gains recognised	NC	+
IAS 32	Convertible debenture interest	+	+
IAS 32	Preference dividends	–	–
IAS 36	Impairments reduced	NC	+
IAS 37	Provisions narrowed	NC	+
IAS 38	Development cost capitalisation	+	+
IAS 39	Marking to market required	+	+
IAS 40	Investment property gains	+	NC
IAS 41	Gains on biological assets	+	+

Key:

\+ = more or faster recognition of profit

– = less or slower recognition of profit

NC = no substantial change

Note: scores justified in Appendix 1.

between UK and IASB rules are likely soon to be removed by amendments to IFRS announced in 2002. Seven of the most significant remaining issues are shown as '+' or '-' in the 'UK' column of table 4.1. Of course, these could be quite enough to double or cut by half a particular company's pre-tax profit for a particular year. It would not be difficult, however, to adopt IFRS tax-neutrally, as now explained.

Of the seven issues relevant to the UK, two (i.e. pension expenses and capitalisation of development costs) would not affect *taxable* income because they are, in any case, ignored for tax calculations. Another issue (i.e. gains/losses on the revaluation of investment property) is not tax-relevant currently but would require new adjustments from net profit. Incidentally, IAS 40 (Investment Property) provides a good illustration of the likely tax pollution of financial reporting if tax and reporting were aligned. IAS 40 allows a choice of cost-based or fair-value-based measurement. The latter involves taking 'unrealised' gains to income. Presumably, companies would not wish to volunteer for this if it were tax-relevant, so they would choose the less informative cost-basis for financial reporting.

The remaining four issues in the 'UK' column of table 4.1 would require new law to clarify that there should be no tax effects caused by the change to financial reporting.

These issues concern the treatment of interest and dividends on certain instruments accounted for differently under IAS 32 from under FRS 4, and the treatment of gains and losses caused by the marking to market of investments and of biological assets (although this latter is unlikely to be important in the UK).

4.3 EFFECTS OF MOVING TO IFRS ON GERMAN TAX CALCULATIONS

In Germany, far more difficulty would arise if the adoption of IFRS were to be tax-neutral. Fifteen of the issues in table 4.1 are relevant. They fall into two types: (i) where German tax rules specify the calculation of tax numbers (and financial reporting generally follows), and (ii) where German tax calculations follow financial reporting rules. For type (i) (e.g. depreciation and pension expenses), the different amounts charged under IFRS compared with present German tax rules would lead to new adjustments from net profit to taxable income. For type (ii) (e.g. contract accounting and exchange gains), the tax authorities would need to establish new tax rules that would have to be much the same as the existing German financial reporting rules but different from IFRS. These, too, would lead to new adjustments from net profit to taxable income. Many of the adjustments would entail onerous administrative costs. For example, it would be inconvenient to continue recording LIFO numbers for tax calculations if FIFO were used for financial reporting.

It is understood, that the German government proposes allowing the use of IFRS for unconsolidated statements but only for financial reporting purposes; that is, conventional

German accounting will still be required for the calculation of taxable income and distributable income.

4.4 GENERAL EU CONCLUSION

Several EU countries are somewhat like the UK with respect to both closeness to IFRS and separation of tax from financial reporting. Such countries include Denmark, Ireland and the Netherlands. For them, the conclusions based on table 4.1 would apply approximately. That is, if IFRS were adopted compulsorily or optionally for the unconsolidated financial reporting of companies, this could be done tax-neutrally by expanding only slightly the present number of adjustments made from pre-tax profit to taxable income.

Several other EU countries (e.g. Belgium, France and Italy) are rather like Germany with respect to distance of unconsolidated financial reporting from IFRS but closeness to tax. For such countries, adoption of IFRS tax-neutrally would entail the major philosophical shift of separating tax from financial reporting, followed by a large number of detailed adjustments such as those in table 4.1.

Whether adoption of IFRS *should* be tax-neutral depends on whether the present tax bases are well designed for their purpose and whether IFRS income would itself make a good tax base. These issues are addressed in the following chapters, although it has already been suggested that there are strong arguments for separating tax and financial reporting.

SUMMARY

- It is assumed that IFRS will only be required or allowed for unconsolidated financial reporting in a country if reporting is separated from tax.

- Of the hundreds of potentially significant differences between IFRS and current UK financial reporting rules, relatively few would affect the calculation of taxable income. Those few include the payments on certain capital instruments and the gains and losses on marking-to-market of certain assets.

- In Germany, much more extensive problems would arise if reporting moved to IFRS but tax were to be unaffected. Where German tax rules are currently followed for reporting, new adjustments would be necessary. Where German financial rules are currently followed for tax, new tax rules would be needed.

- Most EU countries are either similar to the UK or similar to Germany, so the effects of changing to IFRS can be estimated.

5. Towards a conceptual framework for the calculation of taxable income

'The nation should have a tax system which looks like someone designed it on purpose.'
(William E. Simon, *Blueprints for Basic Tax Reform*, 1977)

5.1 INTRODUCTION

In chapter 2, the relationship between financial reporting rules and tax was examined for two countries, using specific accounting arenas. Taking the example of the UK, the relationship can be seen to be complex, but with an increasing tendency of the tax authorities to wish to follow accounting rules. It was noted that the Finance Act 1998 (amended in 2002) requires the use of financial reporting practice 'subject to any adjustment required or authorised by law'. This suggests that the legislators or the courts need some conceptual basis for determining the necessary adjustment. In particular, the tax authorities still believe that the capital/revenue distinction is an issue to be determined by tax law (Inland Revenue, 1999a).

In chapter 3, it was proposed that the balance of advantage lies with a separation of tax from financial reporting that is larger than that resulting from a few adjustments. This would entail, even more clearly, the need for a conceptual framework for tax.

This chapter assembles some building blocks that will be needed for the creation of a tax framework. Section 5.2 looks at previous research in this area, concluding that writers have identified some reasons why and how tax rules should be different from financial reporting practice. There have been no explicit calls for a tax framework, however, and no attempts to create one. Nevertheless, elements that could be included in a framework have been suggested. In section 5.3, the financial reporting framework is analysed in order to learn lessons for the creation of a tax framework.

5.2 PREVIOUS RESEARCH ON A TAX FRAMEWORK

Introduction

There was no explicit conceptual framework for financial reporting in any country until the last quarter of the twentieth century. There is still no explicit conceptual framework in the context of taxation. This section looks first at the UK theoretical literature on corporate taxation, then at the wider European context. Although no tax framework can be found, certain elements of a framework are suggested by some writers. This section ends by marshalling these.

Lack of a framework in UK literature

Textbooks offer little guidance on the ideal construction of taxable income. This is the case even for those books written by economists or whose titles contain words such as 'policy', 'principle' or 'theory' (e.g. Kay and King, 1980; Pointon and Spratley, 1988; Cope, 1987; James and Nobes, 2000; Lymer and Hancock, 2003). In some cases, these books cover the canons of taxation in general, but few relate theory specifically to business taxation. Where they do, there is coverage of imputation and other systems but no coverage of how taxable income should ideally be calculated.

The Meade Report on *The Structure and Reform of Direct Taxation* (Meade, 1978) is also unhelpful for the specific purpose here. It addresses such issues as whether tax should be based on income or on expenditure in the context of the whole direct tax system, including persons. It does not address specifically the calculation of corporate taxable income.

Freedman (1987) even despairs of the possibility of establishing a framework, and calls instead for objective rules to be applied even-handedly. This search for objectivity is a common theme of writers on tax. However, it could be overdone. For example, all companies could be charged £1m per year. This would be objective and certain, and could be equitably *implemented*, e.g. by demanding the amount on the same day of the year and in cash from all companies. Such a tax might still be regarded as 'bad', however, on the basis of some framework yet to be made explicit.

As noted in section 3.2, several writers have proposed that tax and financial reporting should be separate, but there continues to be a lack of a clear tax framework on which to base differences from financial reporting. This remains the case even in a report apparently on specifically this issue: *The Taxation of Business Income: Aligning Taxable Income with Accounting Income* (Macdonald, 2002). The report notes that:

> *'there is no coherent set of principles to be gleaned from tax law and administration that can be readily identified with any normally accepted concept of income'* (p. 45).

Macdonald suggests that certain features of financial reporting practice might be suitable for tax purposes and others might not be. There is no attempt to construct a conceptual framework for taxable income, and therefore no systematic analysis of what this implies for differences between financial reporting and tax.

US and European contributions

Surrey and McDaniel (1985, ch. 7) examine the construction of a tax base by starting with the Schanz-Haig-Simons definition of income for a period: the market value of rights exercised in consumption and the change in value of the store of property rights. Surrey and McDaniel then consider a few accounting issues (e.g. depreciation and R & D) and propose ways of bringing the US definition of taxable income closer to the ideal.

The literature on European tax harmonisation considers the calculation of taxable income. Devereux and Pearson (1989, pp. 14–15) examine how to achieve fairness between countries. They mention briefly some alternatives to the current system, such as a cash-flow corporation tax that would have 100% allowances for assets but no deduction for interest expenses. Bond *et al*. (2000, pp. 65–66) discuss how to harmonise corporate taxation in the EU but not from first principles; rather, they list the areas to be addressed.

The Ruding (1992) Report describes EU differences in tax bases. It makes recommendations (pp. 212–218) concerning the reduction of these differences. These are not based on a framework, however, and seem to be driven more by the motive of harmonisation. Oddly, the Report recommends an *increase* in the alignment of tax with financial reporting, which is unlikely to *reduce* international tax differences. It also recommends the continuation of choices in certain areas (e.g. LIFO and FIFO) and some arbitrary limits (e.g. declining-balance depreciation rates should not exceed three times the straight-line rate). In many cases, these recommendations seem designed to accommodate existing national practices.

In none of these cases is there an attempt to establish a detailed tax framework and to explain the implications for a comprehensive list of tax rules.

Some elements of a framework

Although no explicit full framework for tax has been proposed, some writers have suggested elements that could be incorporated into a framework. Whittington (1995, p.452) proposes the need for equity, neutrality and administrative effectiveness. Some of his proposed applications of these concepts are not specific to the calculation of corporate taxable income. He does stress the importance of transactions in the context of taxation, however, as opposed to the subjective basis of accruals used for financial reporting. He also notes (p. 455) that the move towards ‘substance’, required in order to implement FRS 5 *Reporting the Substance of Transactions*, would not be ideal for tax purposes. Freedman (1995, p. 432) agrees. Whittington further suggests that, for tax purposes, reliability is likely to be stressed more than relevance to the investor. Green (1995, p. 447) adds the need for the calculation of taxable income to be certain and cost efficient. Macdonald (2002, p. 47) stresses reliability and objectivity, as does Freedman (1987).

Freedman (1995) suggests that:

> ‘financial reporting is concerned with the past, present and future, whereas taxable profits must relate to the taxable period in isolation’ (p. 437).

This is another way of making Whittington’s point that tax law prefers transactions (e.g. the purchase of an asset or the payment of cash to a pension fund) rather than an accrual (e.g. depreciation or pension expense). Nevertheless, this idea of ‘present-oriented’ is too simple. Some elements of tax calculations rely on the past (e.g. writing down allowances for past capital purchases), and other elements ignore the present (e.g. increases in the market value of assets that have occurred in the year). Freedman further observes that the gradual move in financial reporting towards a focus on the balance sheet seems ill suited to tax calculations. It might not serve well the ability-to-pay concept of tax. Macdonald (1995, p. 489) also notes the problem that financial reporting is increasingly taking account of changes in value. Macdonald (2002, p. 48) makes the interesting point that the tax system should not accept revaluations based on replacement cost (or therefore on deprival value) because such a revaluation is not income.

Freedman (1995, p.443) and Macdonald (1995, p.498) both argue in favour of the courts or statutes adopting the principles of SSAP 2. SSAP 2 and its successor standard contain competing concepts that could reasonably lead to a variety of results, SSAP 2’s promotion of prudence above the other accounting concepts was frequently ignored by the standard setters over the following decades and anyway would not be best liked by tax courts. I suggest that the courts would be better off with a purpose-built tax framework rather than relying on an accounting standard and on court decisions themselves based on old financial reporting practices and more recent standards.

The Inland Revenue’s proposals for reform (2003) also hint at some elements of a framework: a broad tax base close to ‘economic income’, the difficulties of taxing unrealised gains, and the desire to achieve certain policy objectives.

5.3 A HIERARCHY OF PRINCIPLES AND RULES

This section examines the relationships between principles and rules in the area of financial reporting, using the conceptual frameworks of the UK and the IASB as examples. The structure developed by Alexander (1999) is used as a starting point. Alexander identifies a three-level structure of principles and rules, and this is discussed by Nobes (2000) and Alexander (2001). The structure is as follows:

- Type A overall criteria, such as fair presentation
- Type B conventions, such as prudence and matching, and
- Type C detailed rules, such as the requirement to value inventory at the lower of cost and net realisable value.

Type A rules might be enshrined in a law. Type B (and perhaps A) rules are contained in a 'conceptual framework' which is particularly addressed to the standard setters, who frame the Type C rules as 'standards'. The conceptual framework can also be used, however, by preparers or auditors of financial statements in order to interpret the standards, to fill in gaps in the standards, to infer the need for extra disclosures, and (depending on how the standards are framed) even to identify cases where departure from the standards would be appropriate.

Type B conventions are in some cases contradictory, so reference to a Type A criterion is necessary in order for standard setters, preparers or auditors properly to trade them off.

It will be useful here to add more detail to Alexander's structure. For example, 'fair presentation' is a criterion at too high a level to be clear. What would be fair for the assessment of the actions of the directors might be different from what would be fair for the prediction of future cash flows. So, it would be better to substitute clearer objectives. Those identified in the IASB *Framework* are decision making and assessing stewardship (paras. 12–14). A similar conclusion is reached in the ASB's *Statement of Principles* (1999, preamble to chapter 1). Neither framework discusses 'fair presentation' or 'true and fair view' in terms of the objectives of reporting (see *Framework*, para. 46; *Statement*, Introduction para. 10). The concept of 'true' is part of reliability, and the concept of 'fair' is related to representational faithfulness. We now turn to such concepts.

The frameworks include several second-order objectives, including understandability, relevance, reliability and comparability. To extend Alexander's terms, the overall criterion might be called Type A1 and the secondary objectives Type A2.

Another aspect of the frameworks is their discussion of constraints. For example, the IASB's *Framework* (para. 44) suggests that the benefits derived from information should exceed the cost of providing it. Such a constraint could not be inferred from any of the Type A2 or lower concepts. This suggests that it must be added in to Type A1 criteria.

The frameworks also refer to the need to trade off one concept against another as a constraint. That is a different form of constraint, however, which can be resolved by making it clear which Type A objectives are the most important.

Type B conventions include prudence and matching. Type C rules come in various levels. An example of a high-level rule would be the requirement never to measure an asset at above its cost. The next level down might be the 'lower of cost and market' rule for inventories. Below that could be the prohibition of LIFO; and one could imagine several layers of detail below that also. Table 5.1 shows such a hierarchy.

If there are multiple objectives or concepts at one level, it will be difficult to arrive at unambiguous answers at a lower level. For example, 'relevance' at level A2 will be ambiguous without clarity on the subject of 'relevant for what?' at level A1. Similarly, the competing A2 objectives of relevance and reliability make it difficult to choose between historical costs and current values.

Table 5.1 An expansion of Alexander's hierarchy for financial reporting

Levels	***Examples of content***
Type A1 Criteria	prediction of cash flows for decision making; checking on the stewardship of management; these criteria are constrained by cost/benefit considerations
Type A2 Objectives	relevance, reliability
Type B Conventions	matching, prudence, realisation
Type C1 Rules	historical cost
Type C2 Rules	lower of cost and net realisable value
Type C3 Rules	prohibition of LIFO

The exact contents of the structure identified in table 5.1 change from time to time. During the second half of the twentieth century, the Type A1 criterion for financial reporting has gradually shifted away from stewardship and towards investor decision making. At least, this is the case for the consolidated statements of listed companies, the main context for the standard setting of the US, the UK and the IASB.

This shift in emphasis has trickled down through the layers of the structure, leading, for example, to increased disclosure requirements (e.g. reporting on segments and discontinuing operations) and increasing use of current values, with the consequent retreat from prudence and the realisation convention.

SUMMARY

- Textbooks, reports and academic papers offer no conceptual framework for the calculation of taxable income. There is widespread recognition of, but little concern about, its absence.

- Elements of a framework can be gleaned from some writers, including the need for reliability and administrative effectiveness. These argue for a transactions-based system and the importance of realisation.

- Financial reporting theorists have identified a three-level structure of objectives, concepts and rules. A more detailed version is proposed here.

6. Proposals for a Tax Framework and Tax Rules

The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the smallest amount of hissing.
(Jean-Baptiste Colbert, attrib., *c*.1665)

6.1 INTRODUCTION

In chapter 2, it was noted that the degree of linkage of tax and financial reporting varies across time and country. A particularly complex relationship has developed in the UK. In chapter 3, arguments against a close linkage were marshalled. This means that a framework is needed in order to establish the rules for tax, although the need is already implied if *any* adjustment is required from financial reporting. Without a framework, the tax rules are likely to be *ad hoc*, incoherent and not suited to their purpose. Chapter 5 assembled some building blocks of a tax framework by examining the contributions of previous research and the lessons that can be learned from financial reporting.

This chapter makes proposals for a tax framework, starting with objectives (section 6.2), then looking at the resulting concepts (section 6.3), before applying these to the creation of tax rules (section 6.4). Although the assembled building blocks are largely related to the UK or to the IASB, there are no obvious reasons why the central objective of business taxation should differ internationally or why the tax framework could not be internationalised. Nevertheless, to do so it would be necessary to consider the effects of different legal systems, attitudes to compliance, and so on.

6.2 OBJECTIVES

Following the structure discussed in section 5.3, it is necessary first to establish the top level of the frameworks, i.e. the objectives. What is the equivalent to ‘the objectives of financial reporting’? At first sight, the answer is ‘the objectives of taxation’. If so, there might be several objectives, headed by the raising of revenue and including the redistribution of income, the stabilisation of the economy and correction of market failure. There are some problems here, however. First, the raising of revenue is too vague an objective for the present purpose: it could be achieved with taxes as diverse as a poll tax or motorway tolls. Secondly, some of the other objectives (e.g. redistribution of income) seem to have little relevance for corporate taxation. Others (e.g. stabilisation) can be achieved by changing the tax *rate* rather than by changing the definition of taxable income.

It is proposed here that a clearer scope is needed in order to identify clearer objectives. The scope suggested is not 'taxation' but 'the calculation of the taxable income of businesses'. So, the Type A1 question becomes 'What are the objectives of the calculation of the taxable income of businesses?' Incidentally, this report is not set specifically in the context of a corporate income tax. Whether or not corporations are taxed separately from their owners does not affect the need for the calculation of taxable income.

I propose that the main objective is to enable an equitable amount of tax to be collected from each business once the total corporate income tax take has been established. The tax authorities in democracies generally respond to the widespread desire for equity. It brings incidental advantages with it. For example, tax evasion tends to be lower if taxes are considered equitable (e.g. Spicer, 1975). Also, at the extreme, if taxes are inequitable, political trouble can ensue, such as tea parties in Boston or poll tax riots in London.

A preliminary issue is whether the concept of equity can apply to inanimate entities such as businesses. It is assumed here that business income is either immediately allocated to persons (as in the case of unincorporated businesses) or is eventually so allocated (as sooner or later it is allocated to the owners of incorporated businesses, sometimes after a tax at the level of the corporation). Consequently, we are not discussing equitable taxation here, but the equitable calculation of what will be allocated to taxpayers for inclusion in their taxable incomes.

It was concluded in section 5.3 that some constraints are of sufficient importance to be included as objectives. In this case, a particular high-level constraint can be phrased as an objective: other things being equal, to inflict as little cost as possible. Costs come in various forms, such as the administrative cost to the government, the compliance costs to the taxpayer, and the inefficiency caused when economic decisions are affected by their expected tax consequences. It is assumed here that governments would, other things being equal, always welcome higher net revenues but that they realise the political importance of collecting no more tax than is absolutely necessary.

Another constraint is that the tax system should not be used to counter public policy. Here, an obvious issue is that the tax system should not be used to encourage crime by allowing fines to be tax deductible.

A further possible unconnected objective is the achievement of particular political or economic goods, such as the encouragement of investment in deprived regions. In order not to interfere with the main objectives, this 'allocation' objective could be attempted by other means, such as government grants or reduced tax rates, but sometimes governments allow unrealistically high depreciation charges for tax purposes.

In summary, it is suggested that the main Type A1 objective is:

- the collection of an equitable share of tax from each business at the minimum total cost (defined broadly).

Secondary objectives are:

- the avoidance of the encouragement of law breaking, and

- the achievement of certain specific political or economic goals (e.g. allocation of resources).

These secondary objectives can vary internationally. So, it is important to leave them aside from the main considerations in order to have a chance of creating a tax framework suitable for international use.

6.3 CONCEPTS

The implications of the above Type A1 criteria for the lower level concepts can now be considered.

Equity

The equity objective is generally thought to lead to the ability-to-pay concept. This, in turn, leads to a broad definition of income so that companies cannot escape tax by arranging for their 'income' to fall outside the tax net. The most obvious point here is that non-trading income and capital gains should be included. Similarly, the scope of expenses should be wide, including interest and some form of allowance for the using up of capital. Surrey and McDaniel (1985, p. 188) point out that 'ability-to-pay' may be an unhelpful concept as it might allow consumption items (e.g. charitable donations or medical expenses) to be deductible. Instead, we could concentrate on taxing 'income'; that would lead to equity as long as the definition is sound.

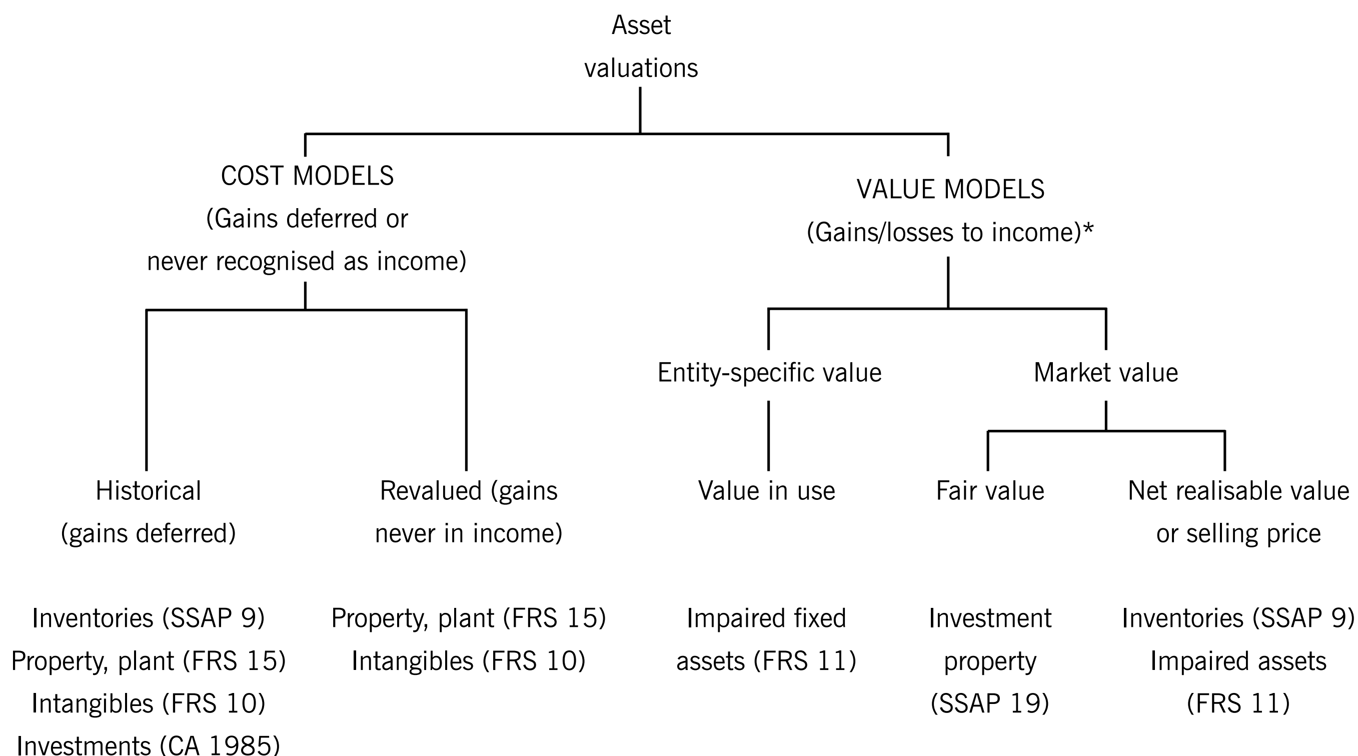
Why could we not use for tax the definition of income used for financial reporting? If an amount is a fair measure of a company's income for investors, why is that not the fair amount to be taxed? The general answer, from earlier chapters, is that financial reporting has a different purpose. There is now a more specific answer, however: financial reporting no longer focuses on measuring income. As noted in chapter 5, the financial reporting frameworks begin with the definitions of asset and liability, leaving profit as a residual difference between gains and losses:

'Ownership interest is the residual amount found by deducting all of the entity's liabilities from all of the entity's assets. … Gains are increases in ownership interest not resulting from contributions from owners. Losses are decreases in ownership interest not resulting from distributions to owners.' (UK Statement of Principles, paras. 4.37 and 4.39)

The fact that income is a residual is not of itself fatal. What is fatal is that assets and liabilities are valued on so many different bases that the resulting total of changes in value is incoherent. Figures 6.1 and 6.2 show the position for the UK in 2002. Even more complex charts for IASB requirements are shown by Nobes (2001 and 2003).

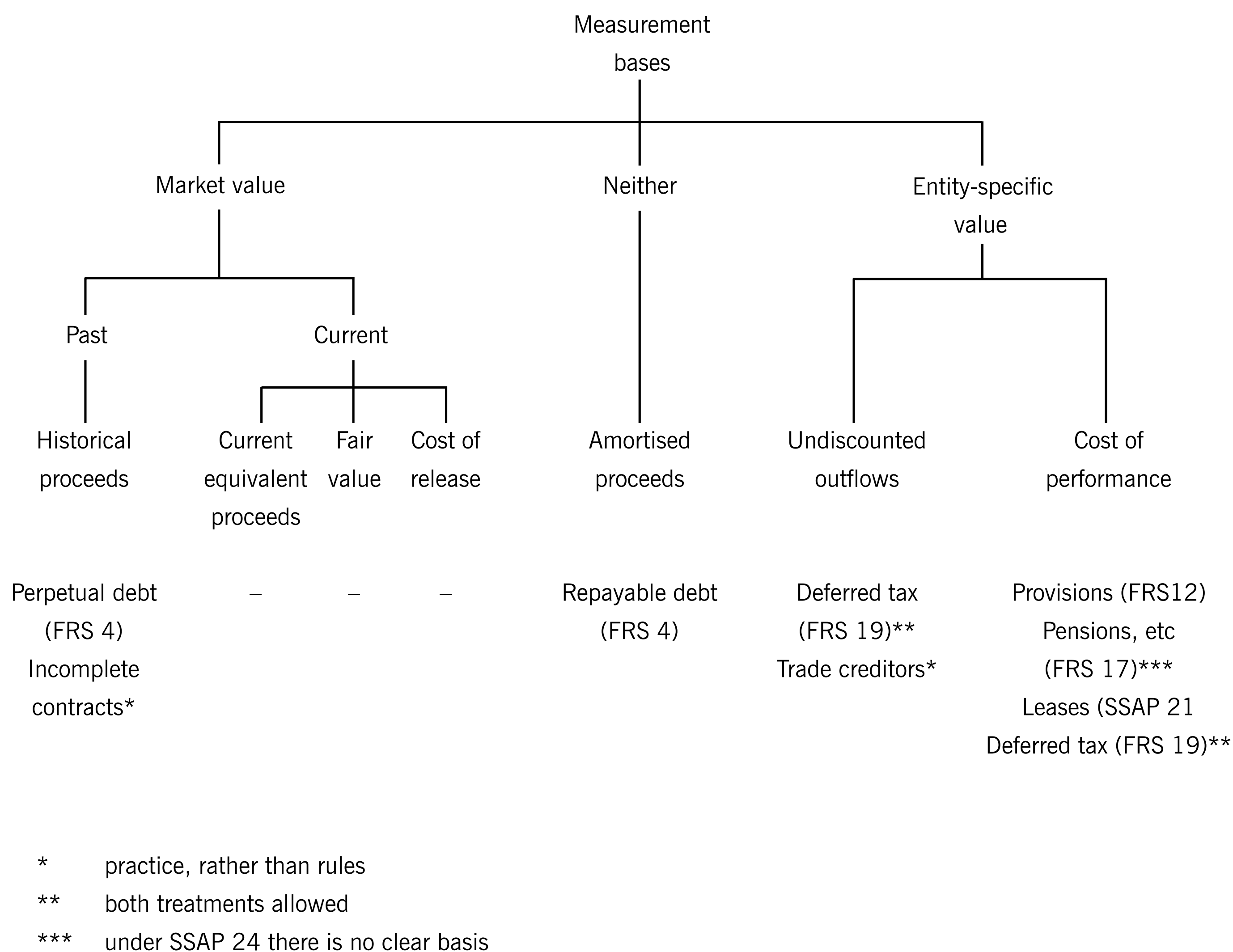
The ASB and the IASB reached the logical conclusion of this approach in 2003 by working on proposals to remove the conventional profit and loss account and to replace it with a statement of performance that might more accurately be called a 'statement of non-owner debits and credits falling out of the balance sheet'. The conventional starting point for tax calculations (i.e. net profit before tax) will therefore disappear, making it even clearer that a concept of income for tax is needed.

Figure 6.1: Possible UK asset measurement bases classified by cost/value (2001, still applicable 2004)



* Except for investment property

Figure 6.3: UK measurement bases for liabilities (2002, still applicable 2004)



* practice, rather than rules
** both treatments allowed
*** under SSAP 24 there is no clear basis

Interestingly, one of the features of the new proposals is that re-measurements should be separated from other elements of income. This may reveal a number more suitable than the present net income as a starting point for tax calculations.

The problem is that there are many plausible definitions of income for a period. This topic was introduced in section 5.2. Applying this to corporations, income could be:

- the amount that could be distributed in the period without diminishing the company's capital (monetary or physical)
- the amount that could be distributed in the period without diminishing the company's ability to distribute the same amount in future periods.

It is suggested here that maintenance of physical capital is not a useful concept in a fast-changing world, particularly in a country such as the UK where manufacturing industry is increasingly marginal. So the maintenance of monetary capital is more appropriate. Ideally this implies adjustments for inflation, but that is a complex area (e.g. Whittington, 1983). It can possibly be ignored, on the grounds of simplicity and administrative efficiency, particularly in times of low inflation.

It is not clear whether equity demands some form of the realisation concept. If a company's assets rise in value, it is better off and therefore has, in some sense, a greater ability to pay tax. However, unless the assets have been sold, the gain is an estimate. Also, a tax on unsold assets might impose an unreasonable liquidity burden on the company. This would not be equitable. One problem of ignoring increases in value until assets are sold is that the company can choose to postpone tax by choosing not to sell. Would it be relevant if the assets could *easily* be sold? Is 'readily realisable' almost as good as 'sold'?

On balance, my conclusion is that concepts other than 'sold' are too vague for tax purposes. Furthermore, taxation could not reasonably be based on the valuations currently used for financial reporting because they are incoherent, as explained above. Therefore, the tax system would need its own valuation basis. In principle, this should be applied across the board to all assets and liabilities. That suggests valuation at a market exchange price, i.e. what an asset could be sold for or what a liability could be settled for. Other current valuation concepts are inappropriate for taxation. For example, an increase in the depreciated replacement cost of a building should surely not be seen as taxable income (if it is income at all); and the discounted net cash flow expected from an asset is too subjective and expensive to calculate.

If one is trying to measure income, it makes no sense to revalue some assets and liabilities but not others, although any universal revaluation basis (including market prices) would be expensive for taxpayers and tax auditors. It would also offend the need for certainty. The conclusion is that the need for objectivity and certainty argues in favour of the tax system's traditional reliance on transactions and realisation.

Minimum total cost

Cost to the taxpayer is reduced by simplicity and objectivity. Judgement is expensive, and this argues in favour of objectivity, assisted by basing taxable income on recorded transactions of purchase and sale rather than on valuations, as explained above.

Another aspect of cost concerns neutrality: the avoidance of unintended effects on decision making by the taxpayer. Here, again, a wide scope for income is helpful so as not to encourage wasteful manoeuvring. Corporate taxation has been accused of encouraging debt-financing rather than equity-financing because interest is generally tax-deductible, whereas

dividends are not. If this was seen as a problem, it would be necessary to move towards an even wider 'entity concept' of income. Also, as suggested in chapter 3, the unintended effect of tax pollution of financial reporting should be avoided if possible. This means that tax-relevant revenues and expenses should not rest upon judgements made for financial reporting.

From the point of view of the tax collectors, too, simplicity and objectivity help to reduce cost. The reduction of tax evasion is also aided by simplicity and objectivity, and by perceptions of equity.

Comparison with a financial reporting framework

Table 6.1 lists the assumptions, concepts and constraints of the IASB's *Framework* and suggests which are less relevant or are even disadvantageous for tax purposes. Somewhat different conclusions would be reached using the UK's *Statement of Principles* because it has a different list of concepts and different definitions.

The first point is that some terms have a different meaning in the tax context. For tax, neutrality means lacking in unintended side effects rather than unbiased, although the latter concept is also useful for tax. The concept of relevance changes its significance as objectives change: what is relevant for decision making would not be as relevant for assessing ability to pay tax. Similarly, the benefit/cost comparison needs to be re-written in terms of cost minimisation. Some concepts are less important in the tax context, and some may be harmful.

Let us now go through all the concepts in approximately the order of table 6.1. The accruals concept may be harmful in the context of taxation because it lacks objectivity, as noted by previous writers. The going-concern assumption is less relevant because the tax basis moves away from predictions about future use.

Table 6.1: IASB's assumptions, concepts and constraints

	Different meaning	*Important for tax*	*Less important*	*Harmful for tax*
Accruals				yes
Going concern			yes	
Understandability			yes	
Relevance:	yes	*		
Materiality				yes
Reliability:	yes	*		
Faithful representation			yes	
Substance over form				yes
Neutrality	yes	yes		
Prudence				yes
Completeness		yes		
Comparability		yes		
Timeliness			yes	
Benefit/cost	yes	yes		

* = see the components of the term, below.

Understandability is less relevant when there is only one user of the information and when the objective is not decision making. Less attention need be given to faithful representation when objectivity is already being stressed.

The need for objectivity also militates against materiality, substance over form and prudence. Materiality introduces judgement and inaccuracy. Substance over form implies departure from the readily observable legal position towards some more complex assessments. In principle, the search for substance would be useful in the field of taxation. Despite some moves in this direction (McBarnet and Whelan, 1991), however, it would require an important change in approach by the legal system. Prudence introduces the need to compare cost with subjective values, such as net realisable value or value in use (i.e. discounted expected net cash flows).

A form of completeness is important: the tax authorities need a full set of relevant information. Generally, this set can be specified more readily in the context of tax than in that of financial reporting, because of the single user and the backward-looking purpose. A version of comparability is also important in that the taxpayers' incomes need to be properly compared in order to ensure equity.

The concept of timeliness is important for financial reporting because delay damages the relevance of information for decision making. Although the government would benefit from speed in tax collection, however, the passing of some weeks does not make the data any worse for a tax purpose. Lastly, as noted above, the benefit/cost comparison is important for tax once its meaning has been adjusted.

Summary on Type B concepts for a tax framework

The desires not to encourage law breaking but to achieve certain political or economic goals can be put into effect by particular technical Type C rules, without the need for Type A or B concepts. The main Type A1 objective (equitable collection at minimum cost) has, however, implied several Type A2 and B concepts. The higher-level concepts (Type A2) include efficiency and a fair definition of income.

The measurement of income is assisted, at the next level down (B conventions), by comprehensiveness and by the capital/revenue distinction. A taxpayer's ability to pay is also increased by realisation. The latter concept also assists with objectivity, which serves efficiency. Other Type B conventions that help efficiency are certainty and neutrality. Several concepts from financial reporting are excluded or limited, however: notably accruals, materiality, substance over form, and prudence.

The Type A and B items of the proposed framework can be put together as in table 6.2. Objectives and concepts at this level of abstraction can be difficult to operationalise (Alexander, 1999, p. 240). The financial reporting frameworks get more precise when they

turn to definitions and recognition criteria for elements (e.g. assets). The above discussion implies that, for tax purposes, primacy needs to be given to the elements of income and expense, and that recognition should be transaction-based. Unless there is a more radical move to a cash flow basis, the continued need for a capital/revenue split means that the interplay between the definitions of 'asset' and 'expense' cannot be avoided for tax any more than it can be for financial reporting.

The tax framework may be clearer than the reporting frameworks when it comes to measurement. The latter frameworks offer little guidance, noting that various forms of historical and current values could be used. As noted in section 5.3 for financial reporting purposes, current values are likely to be more relevant but historical cost is more reliable. . For tax purposes, however, the use of historical cost is likely to be both more relevant and more reliable than other measures. This is because, as explained above, the tax system should be based on past transactions.

Table 6.2: A conceptual framework for tax

Levels	*Content*
Type A1 criteria	Collection of equitable share of tax at minimum cost; no encouragement of law breaking; specific political or economic goals
Type A2 objectives	Fair definition of income; efficiency
Type B conventions	Comprehensiveness; realisation; capital/revenue distinction; objectivity/certainty; neutrality

6.4 TYPE C RULES

Some examples of Type C rules that would follow from the higher-level concepts in the framework of table 6.2 can now be discussed.

Comprehensiveness requires rules that ensure the inclusion, at least eventually, of income in the form of interest, dividends and capital gains, as well as from trading. Objectivity/certainty suggests that tax-relevant revenues should not rest upon judgements. This means that any revaluations of assets should be ignored. The same applies to 'revaluations' caused by currency movements affecting unsettled monetary balances. Similarly, profit on contracts should be taxable on completion.

The implications for depreciation and impairment of tangible and intangible assets need to be considered. I suggest that none of these re-measurements should be relevant for tax. If taxpayers are allowed to wait until there is a transaction before paying tax on a gain, then they can wait before getting a deduction for a loss. For assets likely to lose value (e.g. machinery), the tax authorities could allow a fixed percentage of cost per year. This would be adjusted to actual loss at the time of sale. In UK terms, this means capital allowances with balancing charges. This approach would avoid the large judgements involved in measuring value in use, which is the normal impaired value for an asset (e.g. under FRS 11 or IAS 36). In general, it would also avoid the temptation for companies to exaggerate capital losses for tax purposes.

The same approach could be extended to inventories. That is, for tax purposes, they should be valued at cost until sale. This means not using the 'lower of cost and market' rule, because market value is subjective. Interestingly, this used to be the approach in China (Ng and Yuen, 2001). Also, in Japan, write downs are only allowed under special conditions (Sawa, 1998, p.154). For the measurement of the cost of using up inventory, I would require FIFO for tax purposes, on the grounds that it is likely to be close to the actual cost of inventory used.

Interest and R & D expenses (except those for tangible fixed assets) should be tax deductible, irrespective of any capitalisation for financial reporting. The accruals basis could be allowed for interest and for other straightforward expenses such as wages. This would add simplicity without serious risk of manipulation.

For allowances against bad debts, I would take the same view as the tax authorities in the UK, the US and France. That is, specific allowances that can be checked against particular customers should be allowed, but general allowances should not be.

Type B concepts suggest that all leases should be treated as operating leases for tax purposes. This is more objective than following the financial reporting rules, especially as at present they involve capitalisation of only some leases even though all non-cancellable leases entail assets

and liabilities. Even if all leases were capitalised for financial reporting purposes, as proposed by some standard setters (e.g. McGregor, 1996), it would be better to capitalise none of the leases for tax purposes because the proposals involve substantial judgement in terms of calculating the proportion of the leased asset that should be capitalised.

The current treatment of asset-related government grants under UK rules (SSAP 4) or IASB rules (IAS 20) is to take them to income over the life of the asset. It is not clear why the grants are not income immediately, assuming that the conditions are met. This is the conclusion reached elsewhere (e.g. Westwood and Mackenzie, 1999; Nobes, 2003, section 2.5). It is also the conclusion in IAS 41 (paras. 34 and 35) for grants related to biological assets. Consequently, to use the financial reporting basis for tax purposes seems unsatisfactory and anyway rests on estimates of lives. To base income on compliance with conditions also introduces judgement. Presumably, the simplest solution is for the granting departments to liaise with the tax authorities and to fix the size of grants on the basis that they are not taxable.

Turning to liabilities, I suggest that the creation of provisions should also be ignored for tax purposes. The arrival of FRS 12 (or IAS 37) has anyway narrowed down the scope for provisions. Many of the remaining provisions (e.g. de-commissioning or pensions) involve great judgement, including discounting.

Income from investments should be treated on a dividend received (or receivable) basis. This means that the equity method (e.g. as used in investor statements in Denmark and the Netherlands and optional by IAS 27.29, IAS 28.12) would not be allowed.

The correction of errors (whether ‘fundamental’ or not) and the results of changes in accounting policy should be passed through taxable income rather than being treated as prior-year adjustments. Otherwise, they would never be taken into account for tax.

Most systems of taxation of corporate income allow losses to be carried backwards or forwards against profits of other periods. The system proposed here would need to do that, especially as it disallows various forms of matching or smoothing, e.g. provisions.

This outline of a tax system based on the above elements is summarised for 16 topics in table 6.3. This differs from the UK tax systems in many ways, but is very close to the tax system in the US, as is explained in chapter 7.

Table 6.3: Proposed type C tax rules

	Accounting topic	*Tax treatment*
1.	Asset measurement	No revaluations
2.	Depreciation	Not allowed, except for scheduled tax depreciation for some assets
3.	Impairment	Not allowed
4.	Inventory basis	Cost (not lower of cost or market)
5.	Inventory flow	FIFO required
6.	Contracts	Completion basis
7.	Foreign currency balances	Settlement basis
8.	Interest	Deductible on accruals basis
9.	R & D	No capitalisation
10.	Bad debt allowances	Deductible if specific
11.	Leases	All treated as operating
12.	Grants	Not taxable
13.	Pension provisions	Not allowed
14.	Other provisions	Not allowed
15.	Investment income	Dividends received and receivable
16.	Errors/policy changes	Through income

SUMMARY

- At the top of a framework are objectives. For the present study, it is not the objectives of taxation that need to be specified but the objectives of the calculation of the taxable income of businesses.
- It is proposed that the main objective is to enable equitable taxation with minimum of cost (broadly defined). Other objectives are to achieve certain political/economic goals and to avoid the encouragement of law breaking.
- The main objectives imply the high-level concepts of ability-to-pay and efficiency. These in turn suggest the need for comprehensiveness, realisation, the capital/revenue distinction, objectivity and neutrality. However, financial reporting's concepts of accruals, materiality, substance over form and prudence are not helpful for tax purposes.
- Tax rules can be derived from these concepts, and section 6.4 examines these for 16 accounting topics.

7. Proposed system compared with national rules and IFRS

7.1 INTRODUCTION

This chapter examines the potential application of the tax base proposed in chapter 6. Section 7.2 compares it with the current tax systems in three countries. One conclusion is that the proposal is fairly close to the US tax system, which suggests that it is practicable.

Suggestions have been made elsewhere that the forthcoming adoption of IFRS in the EU could be used to improve the tax system. For example, the European Commission has begun to consider (EC, 2003) whether IFRS could be used as a tax base. The Commission makes the suggestion, however, in the context of a proposal to base taxation on an EU-wide consolidation. This seems hopelessly ambitious. It would entail four major changes:

- basing taxation on consolidated income rather than on legal-entity income (thus adding many group accounting issues)
- necessitating the preparation of an EU-limited consolidation by companies, which is not currently done for financial reporting or for tax purposes
- basing taxation on IFRS rather than on current domestic financial reporting requirements

  and
- in some countries, introducing the separation of tax from financial reporting.

Simultaneous reform on all these fronts would raise so many problems that it would postpone developments for many years. It is suggested here that attention should be paid to the last two of the above four issues. To this end, section 7.3 examines how the proposed tax base of chapter 6 compares with IFRS and how it could be adopted if IFRS were being used by companies.

7.2 PROPOSALS COMPARED WITH EXISTING TAX RULES

Introduction

This section compares the proposed tax system of section 6.4 (as summarised in Table 6.3) with existing tax rules in three countries: the US, Germany and the UK. The US tax system is summarised in Appendix 2 to this report. In the case of Germany, the tax system and the accounting system are very similar, as explained in chapter 2. The UK tax system has also been outlined in chapter 2.

Table 7.1 shows how the tax systems of the three countries relate to the 16 detailed proposals of table 6.3. For each country, each proposal is scored on the following scale (explanations of the scores are given in Appendix 3).

YD = Yes, the tax rule is the same as proposed here, but different from financial reporting (FR) practice.

YD* = Yes, the tax rule is approximately the same as proposed here, but different from FR practice.

Y = Yes, the tax rule is the same as proposed here, and the same as FR practice.

Y* = Yes, the tax rule is approximately the same as proposed here, and the same as FR practice.

N** = No, the tax rule is not the same as proposed here but constrains tax practice in another way; FR practice follows.

N* = No, the tax rule is not the same as proposed here; the FR rule is followed approximately for tax but not exactly.

N = No, the tax rule is not the same as proposed here; the FR rule (or choice) is followed exactly for tax.

Table 7.1: Similarity of proposals to existing tax systems

	Proposals	*US tax*	*German tax*	*UK tax*
1	No asset revaluation	Y	Y	YD
2	No depreciation	N**	N**	YD
3	No impairment	YD	N	YD
4	No 'market' for inventory	N	N	N
5	FIFO required	N	N	Y*
6	Completion basis	YD	Y	YD*
7	Settlement basis	YD	N	N*
8	Interest accruals	Y	Y	Y
9	R & D treated as expenses	Y	Y	Y
10	No general bad debts	YD	N**	YD
11	All leases operating	YD	Y*	N*
12	Grants	Y	N**	YD*
13	No pension provisions	YD	N**	YD
14	No other provisions	YD*	N**	N
15	Dividends receivable	Y	Y	Y
16	Errors through income	YD	Y	YD

Note: see text for explanation of codes.

The rest of this section analyses the data in table 7.1 in order to answer four questions.

- How similar are the existing tax systems to the proposals in this report?
- How is objectivity maintained in the existing tax systems?
- How polluted by tax is financial reporting in the three countries?
- How administratively efficient are the existing tax systems?

Similarity to proposals here

Table 7.1 shows that this report's proposals are very similar to the current US tax system (i.e. most proposals are shown with a code beginning with 'Y' in the US column). In Germany and the UK, also, there are several examples of scores beginning with 'Y'. The only proposal with no current application in any of the three countries is the requirement to value inventories at cost, although even this has been done in some countries, as noted in section 6.4.

How objectivity is maintained

One of the key characteristics required of a tax system is objectivity, as discussed in chapter 5. In order to obtain this, the current German tax system follows financial reporting where it involves little judgement ('Y' cases) or imposes detailed control on the deductible expenses where there would otherwise have been judgement (N** cases).

For the US, judgement is controlled through the tax system having its own special rules, which are nearly all like those proposed here (YD). Similarly, for the UK, most scores are either YD (i.e. special tax rules different from accounting practice, as proposed here) or N* (i.e. special tax rules that are not like those proposed here but are similar to accounting practice).

How polluted by tax is financial reporting?

Table 7.1 also gives a measure of tax pollution. In nearly all the cases with 'N', 'N*' or 'N**', there is a risk of tax pollution. For example, for 'N', there will be a temptation to increase depreciation, impairment or provision expenses or to choose a method (e.g. LIFO) for tax reasons. For 'N**', it will be normal practice to charge the maximum allowed by tax laws. For 'N*' in the case of UK leases, there will be a temptation to classify leases on the basis of the tax results.

Administrative efficiency

The main argument in favour of aligning tax and financial reporting is efficiency. However, this will only be fully achieved if the tax rules are *exactly* the same as financial reporting rules. If there are any differences, the need to learn two sets of rules remains. In table 7.1, only those items scored ‘Y’ and ‘N’ are fully efficient. There are few of these for the US or the UK. For the UK, the attempts to increase efficiency by aligning tax and financial reporting have therefore not borne much fruit, but they have added tax pollution. Furthermore, it might be administratively more efficient for both taxpayer and tax collector to have simple, stable tax rules rather than following complex, ever-changing financial reporting rules.

The German system is efficient in the sense intended here, but this entails much tax pollution.

7.3 ADJUSTING FROM IFRS TO THE PROPOSED TAX SYSTEM

It was assumed in chapter 4 that IFRS would only be allowed or required for the financial reporting of tax-paying entities if tax were separated from financial reporting. Let us further suppose that the tax authorities have an implicit framework such as that proposed in this report (summarised in table 6.2). It would then become useful to establish a standardised scheme of adjustments from IFRS financial reports to a definition of income suited to tax purposes and based on a stable set of tax rules.

This section specifies the adjustments necessary from IFRS to the proposed tax system of chapter 6 (summarised in table 6.3). Table 7.2 lists the adjustments related to the 16 accounting topics of chapter 6. Item 5 (inventory flow) would be removed if IASB amends IAS 2 as proposed in 2002. Another item (share-based payments) would be added, however, if the IASB were to proceed with ED 2 of 2002.

Table 7.2: Adjustments necessary from IFRS income to proposed tax basis

1	Asset measurement	Remove any revaluations (IAS 16, IAS 38, IAS 39, IAS 40, IAS 41)
2	Depreciation	Remove any depreciation expense (IAS 16 or IAS 38); impose a schedule for tax purposes
3	Impairment	Remove any impairment losses or reversals of them (IAS 36)
4	Inventory basis	Remove any reductions to net realisable value (IAS 2)
5	Inventory flow	Correct to FIFO (IAS 2)
6	Contracts	Remove any profit based on percentage of completion (IAS 11)
7	Foreign currency balances	Remove any unsettled gains or losses (IAS 21)
8	Interest	Reverse any capitalisation (IAS 23); reverse any adjustments to interest/dividends (IAS 32)
9	R & D	Reverse any capitalisation (IAS 38)
10	Bad debt allowances	Remove any changes to general provisions (IAS 39)
11	Leases	Remove any depreciation and interest expenses; lease rentals to be charged for tax (IAS 21)
12	Grants	Remove any income from government grants (IAS 20)
13	Pension provisions	Remove any expenses; cash payments to be charged for tax (IAS 19)
14	Other provisions	Remove any changes to provisions (IAS 37)
15	Investment income	Reverse any equity accounting (IAS 27, IAS 28)
16	Errors/policy changes	Take through income, not as prior-year adjustments (IAS 8)

Although the adjustments of Table 7.2 are numerous, they are generally straightforward. They mostly entail substitution of a complex, subjective number by a simpler, objective one. The tax base can remain the same from year to year. Also, the tax base can be the same for all companies even if some are using IFRS whereas others are using domestic rules. As noted earlier, nearly all these adjustments are currently made in either the US or the UK. This all suggests that these proposals are practicable.

SUMMARY

- The European Commission's proposal to use IFRS for a consolidated EU tax base is regarded as impracticable in the medium term.

- For the sixteen features of the proposed tax base, comparisons are made with the US, German and UK tax bases. The proposed features are nearly all found in at least one of these countries, the US base being the closest.

- The three countries have different ways of ensuring objectivity for tax purposes. For some topics, tax uses objective financial reporting rules; for others, it is necessary to impose objective tax rules for tax or for both tax and reporting. As a result, the degree of tax pollution varies internationally, as does the administrative efficiency.

- A standardised scheme of adjustments from IFRS to the proposed tax base is created for the 16 accounting features.

Appendix 1
Explaining the scores of table 4.1

Topic	*Germany*	*UK*
IAS 2 (LIFO)	Used when prices are rising in order to reduce profit. Therefore, profit would rise if LIFO were banned.	–
IAS 2 (NRV)	For inventories, replacement cost is generally lower than NRV (because it excludes a profit margin). So, use of NRV would reduce write offs.	–
IAS 8	Treating corrections as prior-year adjustments would remove them from income.	–
IAS 11	Taking gains as production proceeds would speed up recognition.	–
IAS 16	Depreciable lives would rise, and special depreciation would be removed.	–
IAS 17	More leases would be capitalised, leading to replacement of rental expense by depreciation and interest.	–
IAS 19	Pension expenses would take account of pay rises and current interest rates.	Moving from SSAP 24 or from FRS 17 would affect profit.
IAS 21	Gains currently postponed until settlement.	–
IAS 32 (convertibles)	Part would be treated as equity, therefore interest treated as dividend.	As Germany.

Topic	*Germany*	*UK*
IAS 32 (preference)	Some would be treated as liabilities, therefore dividends treated as interest.	As Germany.
IAS 36	Impairments presently based on fall in market value, and not reversed.	–
IAS 37	Provisions would only be made when there is an obligation.	–
IAS 38	Some development costs would be capitalised.	–
IAS 39	Investments would be marked up as well as down.	Investments would be marked up and down, whereas many are presently held at cost.
IAS 40	Presumably, German companies would retain cost method.	If revaluation is continued, gains would go to income.
IAS 41	Market basis rather than cost.	As Germany.

Appendix 2
Calculation of taxable income in the US

Under the current Internal Revenue Code (IRC), there is no general requirement of conformity between taxable profit and financial statement profit in the US. There is an apparently strong link between tax law and accounting, however, in Section 446(a) IRC 1986, which states: 'taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books'. Most companies adopt the accruals method and 'generally accepted accounting principles' as their 'method of accounting' for tax profit calculations. Relatively recent changes make clear that the phrase 'method of accounting' may be defined in such a way as to permit divergence from financial reporting in a number of circumstances.

Consequently, using the terms of section 2.2, there are many Category I disconnections (e.g. depreciation and lease accounting). Given the detailed nature of US accounting and tax regulations there are, nonetheless, some examples of Category III (accounting leads) and of Category IV (tax leads). Inventory valuation is a topic where tax rules state explicitly that 'best accounting practice' should be adopted to find appropriate valuation rules, provided 'income is clearly reflected'. In normal circumstances, therefore, tax and accounting valuations are identical. Both sets of rules permit companies to choose a valuation method from a range of options: FIFO and LIFO are within the range of acceptable flow assumptions. Given that the tax rules normally require conformity of flow assumption with financial reporting, the tax option that has the most beneficial tax effect (e.g. LIFO in periods of rising inventory costs) will tend to be adopted for financial reporting, to the exclusion of other options. Therefore, characterisation of the tax/accounting relationship as Category IV, rather than Category II, seems appropriate. The close link between accounting and tax for this topic is made clear by the requirement that taxpayers must obtain tax authority approval for any change in method of valuing inventory.

Appendix 3
Explaining the scores of table 7.1

For the US column (details in Appendix 2)

1. Tax rule and financial reporting (FR) rule require cost.

2. Certain depreciation rules are established for tax purposes, e.g. reducing balance is allowed.

3. See 1.

4. Lower of cost and market used for tax and FR.

5. LIFO, FIFO or average cost allowed for tax, as used for FR.

6. Completion basis for tax; percentage basis for FR.

7. Settlement basis for tax; closing rate for FR.

8. Tax follows FR.

9. Tax rule and FR rule require expensing.

10. Only specific provisions allowed for tax.

11. Any capitalisation followed for FR is ignored for tax.

12. There are no specific rules on grants, so capital grants are not income and not taxable.

13. Pension expenses are deductible when paid (to pension or to pension fund).

14. Other FR provisions not allowed for tax until paid.

15. Tax follows FR.

16. Fundamental errors corrected by prior-year adjustment for FR but through income for tax purposes.

For German column (some details in section 2.3)

1. Tax follows FR rule of cost.
2. Depreciation maxima specified in detail by tax law; followed for FR.
3. Tax follows FR rule which measures impairment by reference to market values.
4. Lower of cost and market used for tax and FR.
5. LIFO, FIFO or average cost allowed for tax, as used for FR.
6. Tax follows FR rule of completion basis.
7. Tax follows FR rule of 'lowest value'.
8. Tax follows FR.
9. Tax follows FR rule of expensing.
10. Tax inspectors will control the size of general provisions.
11. Leases are classified for tax and FR on the basis of a tax rule, mostly as operating leases.
12. Grants are treated as immediate income for FR if they are not taxable; otherwise they are deducted from the assets.
13. Pension expense maxima specified in detail by tax law; followed for FR.
14. Maxima for other provisions specified in detail by tax law; generally followed for FR.
15. Tax follows FR.
16. Tax follows FR treatment of taking through income.

UK column (some details in section 2.4)

1. Revaluation allowed for FR but ignored for tax.
2. Depreciation disallowed for tax, but capital allowances granted instead.
3. Impairment losses ignored for tax.
4. Lower of cost and net realisable value used for FR and tax.
5. LIFO not allowed for tax or FR, although average cost and specific identification are allowed for both.
6. Percentage basis for FR, but approximately completion basis for tax.
7. Closing rate used for FR, and approximately followed for tax.
8. Tax follows FR.
9. Tax rule involves expensing; FR rule allows capitalisation of some development costs but this is very rare.
10. Only specific provisions allowed for tax.
11. The lease classification used for FR is approximately followed for tax.
12. Grants are treated as income over the life of the assets for FR. The tax rules vary by grant.
13. Pensions expenses are deductible when paid (to pensioner or to pension fund).
14. Tax follows FR.
15. Tax follows FR.
16. Fundamental errors corrected by prior-year adjustment for FR but through income for tax purposes.

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Abbreviations used

ASB	Accounting Standards Board (of the UK)
CA	Companies Act
ED	Exposure draft
EU	European Union
FEE	Fédération des Experts Comptables Européens (Federation of European Accountants)
FIFO	First in, first out
FRS	Financial Reporting Standard (of the UK)
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IRC	Internal Revenue Code (of the US)
LIFO	Last in, first out
R & D	Research and development
SSAP	Statement of Standard Accounting Practice (of the UK)

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